

Office of Chief Counsel
Internal Revenue Service

memorandum

CC:NER:PEN:PHI:TL-N-7089-99
DABreen

date: MAR 9 1999

to: [REDACTED], Case Manager, E: [REDACTED]
Pennsylvania District, [REDACTED]

from: JOSEPH M. ABELE
Assistant District Counsel, Pennsylvania District

subject: Request for Counsel Assistance
[REDACTED] - Sale and Leasehold of Leasehold
Improvements in Fiscal Year [REDACTED]

THIS DOCUMENT INCLUDES STATEMENTS SUBJECT TO THE ATTORNEY-CLIENT PRIVILEGE AND THE ATTORNEY WORK PRODUCT PRIVILEGE. THIS DOCUMENT SHOULD NOT BE DISCLOSED TO ANYONE OUTSIDE IRS, INCLUDING THE TAXPAYER INVOLVED. LIMIT USE OF THIS DOCUMENT TO THOSE WITHIN THE SERVICE WORKING ON THIS CASE. THIS DOCUMENT IS SUBJECT TO I.R.C. § 6103.

This memorandum is in response to an inquiry from Team Coordinator [REDACTED] to Senior Attorney David A. Breen, concerning the tax treatment by [REDACTED] of a sale-leaseback transaction entered into during fiscal year [REDACTED]

ISSUE

Whether the sale-leaseback transaction entered into by [REDACTED] (Taxpayer) and [REDACTED] in FY [REDACTED] should be disregarded for federal income tax purposes, either because it should be recharacterized as a financing arrangement, because it is a sham, or under an alternative theory.

CONCLUSION

The sale-leaseback entered into by Taxpayer in fiscal year [REDACTED] is essentially a sham. Therefore, the form of the transaction may be disregarded for federal income tax purposes. Further, based upon the information provided to date by the Examination Team, the transaction appears to be a financing arrangement between Taxpayer and the "buyer-lessor." Therefore, title in the subject property is retained by Taxpayer and the loss on the sale and related rental expenses claimed by Taxpayer should be disallowed.

FACTS

Taxpayer is [REDACTED] facilities in the United States. Taxpayer operates approximately [REDACTED] stores in [REDACTED] states and the [REDACTED]. Taxpayer's corporate policy is to lease most of its retail facilities from independent third parties. Stores are located in enclosed shopping malls, strip centers, and stand alone structures. Although Taxpayer does not own most of the buildings its stores are located in, Taxpayer does own all of the leasehold improvements.¹

During fiscal year [REDACTED], Taxpayer entered into a sale-leaseback arrangement with a third party whereby Taxpayer sold certain leasehold improvements and immediately leased them back. The particulars of the transaction are summarized below.

Entities Involved

[REDACTED] (Taxpayer) - owns [REDACTED] % of [REDACTED] and [REDACTED] % of the [REDACTED] affiliates entering into the leasing arrangement.

[REDACTED] ([REDACTED]) - wholly-owned subsidiary of [REDACTED]; acts as legal agent for the [REDACTED] affiliates.

[REDACTED] Affiliates - wholly owned subsidiaries of Taxpayer who entered into the leasing arrangement; the assets subject to the sale-leaseback are located in these companies.

[REDACTED] of [REDACTED] - wholly owned subsidiary of Taxpayer, this entity entered into a master lease with the [REDACTED] affiliates for leasing assets.

[REDACTED] - the actual promoter of the leasing arrangement. [REDACTED] is owned and operated by [REDACTED], a known tax shelter promoter.²

¹ The stores involved in the FY [REDACTED] sale-leaseback transaction are primarily located in strip malls and shopping centers where [REDACTED] leases the property.

² (b)(7)a

(b)(7)a

(b)(7)a

of [REDACTED] - wholly owned subsidiary of [REDACTED] entered into the master lease with [REDACTED].

[REDACTED] - this [REDACTED] Bank paid the \$ [REDACTED] cash to Taxpayer. [REDACTED] sold the first year's rent under the master lease to [REDACTED] for \$ [REDACTED].

[REDACTED] - this entity was formed by [REDACTED] as a bankruptcy remote, single purpose corporation for the purpose of purchasing the rental payments.

The Transaction

On [REDACTED], [REDACTED] Taxpayer affiliates, each located in a different state, executed a bill of sale to [REDACTED] (Purchaser) for the sale of leasehold improvements valued at \$ [REDACTED]. The \$ [REDACTED] selling price is based on an appraisal prepared by [REDACTED]. Taxpayer claimed a basis in the leasehold improvements of \$ [REDACTED] and claimed a loss of \$ [REDACTED] on its [REDACTED] Form 1120.

The selling price was paid to Taxpayer as follows:

Cash	\$ [REDACTED]
Note #1	[REDACTED]
Note #2	[REDACTED]
Total	\$ [REDACTED]

Also included in the \$ [REDACTED] note was an "offset option" which Taxpayer elected at the time of the transaction. The offset option was to convert this note to [REDACTED] years of prepaid rent. This leg of the transaction is referred to as an "interim funding step" in the [REDACTED] appraisal.

The rent purchase agreement is between Purchaser-[REDACTED] and [REDACTED]. [REDACTED] was formed by [REDACTED] as a bankruptcy remote, single purpose corporation for the purpose of purchasing the rental payments. Due to the fact that the original \$ [REDACTED] was originally characterized as a component of the \$ [REDACTED] purchase price, the cash was wired from [REDACTED] directly to Taxpayer.³

³ The settlement is summarized as follows:

Gross Cash (from pg. 3 of Note)	\$ [REDACTED]
Less Fee Paid to [REDACTED]	([REDACTED])

Immediately after the sale, [REDACTED] and [REDACTED] entered into a "Master Lease Agreement" whereby [REDACTED] leased back from [REDACTED] the identical assets (leasehold improvements) sold to it. The lease runs for [REDACTED] months, from [REDACTED] to [REDACTED]. The lease states that upon expiration, Lessee can elect to: (1) purchase the assets at fair market value, or (2) return the property to the Lessor. The lease also provides that [REDACTED] may purchase the assets after [REDACTED] months for \$ [REDACTED].

Tax Benefits

The immediate tax benefit to Taxpayer is to generate a loss of \$ [REDACTED] on the purported sale of assets which never leave its control. Additionally, Taxpayer is attempting to recover the cost of leasehold improvements over the [REDACTED] year term of the master lease. Leasehold improvements in the hands of Taxpayer constitute [REDACTED] year property. Taxpayer is substituting depreciation over [REDACTED] years for rental expenses under the master lease over [REDACTED] years.

Value of the Underlying Leasehold Improvements

Taxpayer defends the selling price of \$ [REDACTED] with an appraisal by [REDACTED] which values the assets as of [REDACTED]. The value in this appraisal is \$ [REDACTED]. This value was determined based on an 8% sample of total assets transferred.

The IRS Appraiser argues in her report that the underlying leasehold improvements have zero value, because the items comprising the list of leasehold improvements include items such as paint, wallpaper and caulking. The Team Coordinator and Case Manager confirmed this fact and informed Counsel that the items leased also included ducts for HVAC, doors, hinges and hardware, gates, security alarms and wiring. The engineer argues that all of these items are inseparable and of no value to a purchaser. In her report, the IRS appraiser states:

Fee Paid to [REDACTED]	[REDACTED]
Reimbursed to [REDACTED]	([REDACTED])
Reimbursed to [REDACTED]	([REDACTED])
Net Fee to [REDACTED]	[REDACTED]
Net Cash to Taxpayer	\$ [REDACTED]

Based on the definition of "market value" and the assumed conditions implicit within the definition, the appraised value in the [REDACTED] report does not reflect "market value" for the used leasehold improvements. The "value" of these improvements "in-place" is measured by their contribution to the whole property based on market demand. The landlord retains ownership to the improvements and the real property is owned by the landlord. Therefore, any contributory value of the improvements for the sale of the property benefits the landlord. As stated, previously, there is no "market" and no value to the leasehold improvements as separate and used building components.

Since they have no value, they have no fair market value. Thus, the IRS Appraiser concludes that the \$ [REDACTED] loss claimed by Taxpayer should be disallowed. By similar reasoning, she would also disallow the rental payments claimed by [REDACTED] under the master lease.

In other words, the Examination Team is requesting Counsel's opinion on the use of the "Recharacterization Theory" to disallow the loss and deductions claimed by Taxpayer.

LEGAL ANALYSIS

If the Service can prove that the sale-leaseback was a sham, it may disregard the transaction for federal income tax purposes and recharacterize it as a financing arrangement.

The Service uses the recharacterization theory to assert that a sale-leaseback is a financing arrangement between the seller-lessee and buyer-lessor. If the sale-leaseback is recast as a loan, the seller-lessee is treated as the owner of the property and the buyer-lessor is treated as a lender. The seller-lessee loses its full rental deduction and any losses claimed on the sale leg of the transaction. Thus, the tax consequences of a sale-leaseback are completely altered by the recharacterization of the transaction as a financing device.

In Notice 95-53, 1995-2 C.B. 334, the Service discusses "lease strips" or "stripping transaction" and the tax consequences of these transactions. In this Notice, the Service states that it may apply the substance over form doctrine, the sham transaction theory, and the step transaction theory to sale-leaseback type transactions.

Where there is a genuine multiple-party transaction with economic substance compelled by business or regulatory realities, is imbued with tax-independent motivations, and not shaped by tax-avoidance features, the transaction is not a sham and the Service should honor parties' agreement. In determining if a transaction is a sham, the courts consider several factors, including whether the taxpayer had a business purpose for entering into the transaction other than tax avoidance, and whether the transaction had economic substance beyond the creation of tax benefits.

The sham transaction theory is used by the Service in virtually all sale/leaseback cases. It states that a transaction that is entered into solely for the purpose of tax reduction and has no economic objective to support it is a sham and is without effect for federal income tax purposes. This theory has been upheld by the courts. *Estate of Franklin v. Commissioner*, 64 T.C. 752 (1975); *Rice's World Toyota v. Commissioner*, 752 F.2d 89 (4th Cir. 1985); *Frank Lyon Co. v. United States*, 435 U.S. 561 (1978).

When the transaction is treated as a sham, the form of the transaction is disregarded in determining its proper tax treatment. This enables the Service to determine the actual reality of the transaction by reference to the substance of the underlying transaction rather than its mere form. Whether a transaction is properly characterized for federal income tax purposes as a sale or a financing depends generally upon the substance of the transaction. *Gregory v. Helvering*, 293 U.S. 465 (1935).

The Service must show that the taxpayer was motivated by no substantial business purpose other than obtaining tax benefits and that the transaction did not have economic substance. If a taxpayer attempts to take advantage of a loss that was not economically inherent in the sale, but which was created by the taxpayer through the manipulation and abuse of the tax laws, the loss will not be allowed for tax purposes. *ACM Partnership v. Commissioner*, T.C. Memo 1997-115. The economic substance test focuses on such factors as whether the buyer-lessor acquired an equity interest in the property, whether the documentation supports the transaction, and whether the buyer-lessor has a reasonable opportunity to profit from the transaction.⁴ All of the facts and circumstances surrounding the transaction must be

⁴ See Steele, *Sham in Substance: The Tax Court's Emerging Standard for Testing Sale-Leasebacks*, 14 J. Real Est. tax. 3 (1986).

considered. No single factor will be determinative. A transaction will be treated as a sale if the benefits and burdens of ownership have passed to the purported purchaser. *Highland Farms, Inc. v. Commissioner*, 106 T.C. 237, 253 (1996).

Generally, courts examine a number of factors to determine whether a transaction is a sale or something else, such as a financing or a lease. The Tax Court in *Grodt & McKay Realty, Inc. v. Commissioner*, 77 T.C. 1221, 1237 (1981), enumerated eight factors to consider when making the factual determination of whether a transaction is a sale or a financing:

- (1) whether legal title passed;
- (2) how the parties treated the transaction;
- (3) whether an equity interest was acquired in the property;
- (4) whether the seller was obligated to execute and deliver a deed and the buyer was obligated to make payments;
- (5) whether the purchaser had a vested right to possession of the property;
- (6) which party paid property taxes;
- (7) which party bore the risk of loss or damage; and
- (8) which party received profits from the operation and sale.

See also *Levy v. Commissioner*, 91 T.C. 838, 859-62 (1988).

The courts have generally focused on the risk of loss and treated a transaction as a sale when the assignee bears the risk that the anticipated income will not be paid, where the assignment involves the right to receive future income in exchange for consideration. *Estate of Stranahan v. Commissioner*, 472 F.2d 867, 870-71 (6th Cir. 1973). Conversely, when the assignee is certain that it will be fully repaid, that certainty is characteristic of a loan. *Mapco Inc. v. United States*, 556 F.2d 1107, 1110 (Ct.Cl. 1977).

Upon an analysis of the sale or financing factors stated above applied to the facts of this case, it appears that the transaction was essentially a financing arrangement, not a sale. Specifically, three primary factors support this conclusion:

- 1) the underlying assets were physically inseparable from the leased property;
- 2) the leasehold improvements had zero market value, and
- 3) the parties ignored the express terms of the contract.

(1) Indivisibility of Leased Assets - The Examination Team secured a listing of the assets subject to the master lease. Included in the description of "assets" were items under the heading of "painting", "repairs", "caulking", "used drywall" and "used tiles." The IRS appraiser states that these items are "not divisible." She states further that these items carry no individual identity or value and are not typically items which would be classified as "assets" available for leasing. Essentially she discounts these items as even being available for leasing.

The description of assets listed supports the Examination Team's conclusion that the transaction is primarily a financing arrangement intended to pay for the cost of leasehold improvements and to accelerate the recovery of their cost.

(2) Zero Value of Assets - the IRS appraiser concludes that the fair market value of the leased assets is zero. Stating at page 4 of her report:

There are certain concepts and principles that are implicit within the definition of market value. As previously stated, a market must be identified for value to exist and a market connotes plurality-one buyer does not constitute a market. The Taxpayer was unable to identify any market for the value of the assets.

From the buyer-lessor's perspective, the acquisition of property with little or no value casts considerable doubt on the profitability of the transaction. Clearly, Purchaser's business purpose for entering into the transaction was focused not on the overall profitability of the transaction, but on the anticipated tax benefit.

(3) Disregard of Contract Terms - the Examination Team has determined that the parties failed to adhere to the terms of the master lease. The master lease was executed on [REDACTED]. Between [REDACTED] and [REDACTED] Taxpayer sold or closed [REDACTED] stores containing leasehold improvements subject to the master lease. Section 25 of the master lease, "Substitution of Property" requires Taxpayer to notify the lessor at least annually of any property substitutions. Taxpayer has failed to give any notification to the lessor of any of the

substitutions.⁵

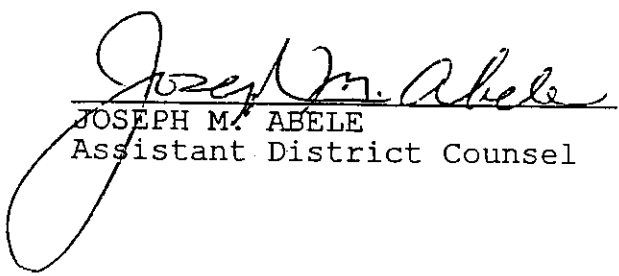
The failure of the parties to comply with the terms of its agreement is further support for the Service's recharacterization of the transaction as a financing arrangement.

A final relevant factor (although not controlling) is that Taxpayer reported the transaction to its shareholders and the SEC as "tax financing", not as a sale-leaseback. In its financial books and records, the transaction is reflected in all instances as a financing arrangement.

SUMMARY

We recommend that the sale-leaseback transaction be recharacterized as a financing arrangement for federal income tax purposes.

This concludes our advice and recommendation. Please feel free to call Senior Attorney David A. Breen at 215-597-3442 with any additional questions you may have. We are forwarding a copy of this advice to the Assistant Regional Counsel (Tax Litigation) (CC:NER) and to the Office of Assistant Chief Counsel (Field Service) (CC:DOM:FS) for mandatory ten day post review. To assure that National Office has sufficient time to review our advice, we request that you refrain from taking any action with respect to this issue prior to March 20, 2000.


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⁵ In fact, Taxpayer's Tax Manager informed the Examination Team that it was the Team's Information Document Request which brought to light Taxpayer's failure to comply with the master lease requirement.